ORIGINAL

BEFORE THE ARIZONA CORPORATION COMMISSION

JEFF HATCH-MILLER
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COMMISSIONER
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COMMISSIONER
KRISTIN K. MAYES
COMMISSIONER
GARY PIERCE
COMMISSIONER

IN THE MATTER OF THE APPLICATION OF ARIZONA PUBLIC SERVICE COMPANY FOR A HEARING TO DETERMINE THE FAIR VALUE OF THE UTILITY PROPERTY OF THE COMPANY FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON, TO APPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN, AND TO AMEND DECISION NO. 67744	Docket No. E-01345A-05-0816
IN THE MATTER OF THE INQUIRY INTO THE FREQUENCY OF UNPLANNED OUTAGES DURING 2005 AT PALO VERDE NUCLEAR GENERATING STATION, THE CAUSES OF THE OUTAGES, THE PROCUREMENT OF REPLACEMENT POWER AND THE IMPACT OF THE OUTAGES ON ARIZONA PUBLIC SERVICE COMPANY'S CUSTOMERS.	Docket No. E-01345A-05-0826
IN THE MATTER OF THE AUDIT OF THE FUEL AND PURCHASED POWER PRACTICES AND COSTS OF THE ARIZONA PUBLIC SERVICE COMPANY.	Docket No. E-01345A-05-0827

NOTICE OF FILING
THE REPLY BRIEF OF
THE RESIDENTIAL UTILITY CONSUMER OFFICE

The Residential Utility Consumer Office ("RUCO") hereby files its Reply Brief in the above-referenced matter.

RESPECTFULLY SUBMITTED this 16th day of February 2007.

Scott S. Wakefield, Chief Counsel
Daniel W. Pozefsky, Attorney

AN ORIGINAL AND SEVENTEEN COPIES
of the foregoing filed this 16th day
of February 2007 with:

Docket Control
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

COPIES of the foregoing hand delivered/
mailed or *emailed this 16th day of February 2007 to:

*Lyn Farmer
Chief Administrative Law Judge
Hearing Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

*Christopher Kempley, Chief Counsel
Legal Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

*Ernest Johnson, Director
Utilities Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

*Thomas L. Mumaw
Karilee S. Ramaley
Pinnacle West Capital Corporation
Law Department
P. O. Box 53999
Mail Station 8695
Phoenix, Arizona 85072-3999

*Deborah R. Scott
Kimberly A. Grouse
Snell & Wilmer L.L.P.
400 East Van Buren
Phoenix, Arizona 85004-2202

*Barbara Klemstine
*Brian Brumfield
Arizona Public Service
P. O. Box 53999
Mail Station 9708
Phoenix, Arizona 85072-3999

*Bill Murphy
Murphy Consulting
5401 N. 25th Street
Phoenix, Arizona 85016

*Douglas V. Fant
Law Offices of Douglas V. Fant
3655 W. Anthem Dr.
Suite A-109 PMB 411
Anthem, AZ 85086

*Dan Austin
Comverge, Inc.
6509 W. Frye Road, Suite 4
Chandler, AZ 85226

Jim Nelson
12621 N. 17th Place
Phoenix, AZ 85022

*Michael W. Patten, Esq.
*Laura E. Sixkiller, Esq.
*J. Matthew Derstine, Esq.
Roshka, DeWulf & Patten, PLC
400 East Van Buren Street
Suite 800
Phoenix, Arizona 85004

*Michelle Livengood, Esq.
UniSource Energy Services
One South Church Street, Suite 200
Tucson, Arizona 85702

*Timothy M. Hogan
Arizona Center for Law in the
Public Interest
202 E. McDowell Road, Suite 153
Phoenix, AZ 85004

*Jeff Schlegel
SWEEP Arizona Representative
1167 W. Samalayuca Dr.
Tucson, AZ 85704-3224

*David Berry
Western Resource Advocates
P. O. Box 1064
Scottsdale, AZ 85252-1064

*Eric C. Guidry
Western Resource Advocates
2260 Baseline Road, Suite 200
Boulder, Colorado 80302

Tracy Spoon, Executive Director
Sun City Taxpayers Association
12630 N. 103rd Avenue, Suite 144
Sun City, AZ 85351

*Gary Yaquinto
Arizona Utility Investors Association
2100 N. Central Avenue, Suite 210
Phoenix, Arizona 85004

*The Kroger Co.
1014 Vine Street, G-07
Cincinnati, Ohio 45202

*Michael L. Kurtz, Esq.
*Kurt J. Boehm, Esq.
Boehm, Kurtz & Lowry
36 East Seventh Street, Suite 1510
Cincinnati, Ohio 45202

*Robert W. Geake
Vice President & General Counsel
Arizona Water Company
P. O. Box 29006
Phoenix, AZ 85038-9006

*Steven B. Bennett
Deputy City Attorney
3939 N. Drinkwater Blvd.
Scottsdale, AZ 85251

*C. Webb Crockett
*Patrick J. Black
Fennemore Craig
3003 N. Central Avenue, Suite 2600
Phoenix, AZ 85012-2913

*Greg Patterson, Director
Arizona Competitive Power Alliance
916 West Adams, Suite 3
Phoenix, AZ 85007

George Bien-Willner
3641 N. 39th Avenue
Phoenix, AZ 85014

*Lawrence V. Robertson, Jr.
Munger Chadwick
P. O. Box 1448
Tubac, AZ 85646

*Lieutenant Colonel Karen S. White
Chief, Air Force Utility Litigation Team
AFLSA/JACL-ULT
139 Barnes Drive
Tyndall AFB, FL 32403

*Sean Seitz, President
Arizona Solar Energy
Industries Association
3008 N. Civic Center Plaza
Scottsdale, Arizona 85251

*Michael M. Grant
Gallagher & Kennedy, P.A.
2575 East Camelback Road
Phoenix, Arizona 85016-9225

*Jay I. Moyes, Esq.
Moyes Storey Ltd.
1850 N. Central Avenue, Suite 1100
Phoenix, AZ 85004

*Kenneth R. Saline, P. E.
K.R. Saline & Assoc., PLC
160 N. Pasadena, Suite 101
Mesa, AZ 85201

*Andrew W. Bettwy
*Karen S. Haller
Assistants General Counsel
Legal Affairs Department
Southwest Gas Corporation
5241 Spring Mountain Road
Las Vegas, Nevada 89150

*Debra S. Jacobson
Director
Government & State Regulatory
Affairs
Southwest Gas Corporation
5241 Spring Mountain Road
Las Vegas, Nevada 89150

*Amanda Ormond
Interwest Energy Alliance
7650 S. McClintock
Suite 103-282
Tempe, AZ 85284

*David C. Kennedy
Attorney at Law
818 E. Osborn Road
Suite 103
Phoenix, Arizona 85014

Joseph Knauer, President
Jewish Community of Sedona
100 Meadowlark Drive
P. O. Box 10242
Sedona, AZ 86339

Tammie Woody
10825 W. Laurie Lane
Peoria, AZ 85345

*Coralette Hannon
AARP Government Relations &
Advocacy
6705 Reedy Creek Road
Charlotte, NC 282215

Michael F. Healy
Morgan, Lewis & Bockius
1111 Pennsylvania Avenue, NW
Washington, DC 20004

*Gary L. Nakarado
24657 Foothills Drive N
Golden, CO 80401

*Jon Poston
AARP Electric Rate Project
6733 East Dale Lane
Cave Creek, AZ 85331

By Ernestine Gamble
Ernestine Gamble
Secretary to Scott Wakefield
and Daniel Pozefsky

ARIZONA PUBLIC SERVICE COMPANY

DOCKET NO. E-01345A-05-0816 et al.

REPLY BRIEF

ON BEHALF OF

THE

RESIDENTIAL UTILITY CONSUMER OFFICE

FEBRUARY 16, 2007

TABLE OF CONTENTS

INTRODUCTION

The Residential Utility Consumer Office ("RUCO") hereby replies to the initial briefs of Arizona Public Service Company ("APS" or the "Company") and other parties. In its Initial Closing Brief, RUCO addressed many of the arguments offered by the parties in their initial briefs. RUCO will not repeat those arguments here.

CRITERIA FOR SETTING RATES

APS correctly notes that the largest conceptual difference between the Company and the positions of the Utilities Division ("Staff") and RUCO concerns whether the Commission should consider future impacts of new rates in the form of projections of financial results in future periods.[1] APS asserts that case law requires that the Commission consider projected impacts of rates to insure that rates will produce a reasonable rate of return. The Commission's traditional rate making approach determines rates based on examination of the expenses, revenues and rate base in a historical test year. RUCO is not aware of any Arizona case that has overturned a Commission rate decision based on a claim that the historical test year approach inevitably fails to satisfy constitutional requirements.

The Commission's traditional rate making approach does consider the future in one important respect. The Commission's examination of an appropriate return on equity looks forward to determine expected returns. Both the discounted cash flow method and the capital asset pricing model include

[1] APS Brief at 3.

estimates of growth or inflation. This level of examination of future return expectations is adequate to meet any requirement that the future impacts be considered by the Commission in setting rates.

In addition, the Commission does recognize adjustments to the historic test year for matters that are both known and measurable changes to conditions that existed in the test year. However, the Commission should not rely on projections of future financial results that are based on shaky estimates of financial results. To do so would undermine the well-established foundations on which the Commission sets utility rates.

RATE BASE ISSUES

Working Capital

APS claims that the non-cash expense of depreciation should be included in its cash working capital calculation, and that its cash expense of interest should be excluded from the calculation. Staff and RUCO agree that APS is wrong on both counts. Because cash working capital is the cash necessary to pay the day-to-day expenses incurred in providing utility service,[2] depreciation expense should not be included in that calculation, but interest expense should be.

APS argues that depreciation, despite it not being a cash item, should be included in the cash working capital calculation because rate base is reduced by the recorded level of depreciation, thereby creating a gap between the time when customers are credited for their payment of depreciation expense and the time

[2] Staff Brief at 17.

they actually pay for it. However, APS' argument overlooks the fact that the rates that customers pay in a subsequent month are not reduced due to the prior month's recording of depreciation expense, because rates change only upon a new finding of fair value in a rate proceeding. In fact, the subsequent month's rates are based on levels of undepreciated plant at the end of the test year in the last rate case. For example, the depreciation APS booked in October 2006 did not result in lower rates in November 2006. Instead, the rates billed in November 2006, and collected in December 2006, were based on the undepreciated plant at the end of December 2002, which was the end of the test year in APS' last rate case.

The Commission has long recognized that depreciation is a non-cash expense, and is not appropriate to include in a calculation of cash working capital. There is no reason to change that well-founded conclusion.

OPERATING INCOME ISSUES

Estimated Net Lost Revenues from Demand Side Management

APS has misconstrued RUCO's reasoning for opposing APS' adjustment of its estimate of revenue losses that could result from the implementation of demand side management ("DSM") programs mostly since the end of the test year. APS asserts that RUCO originally claimed that the 2005 Settlement Agreement precluded APS' proposed adjustment to decrease test year revenues, but then modified its argument in recognition that the Settlement Agreement allows a request for net lost revenues (which APS calls a "conservation adjustment" in its Initial Post-Hearing Brief) in a rate case. The Settlement Agreement does not permit an adjustment to test year revenues in a rate case. Instead, the Settlement Agreement provides that, to the extent actual test year revenues reflect any decrease in revenues due to implementation of effective DSM programs, APS can seek rate recovery based on that lower level of test year revenues.[3] The Settlement Agreement specifically prohibits the recovery of net lost revenues that were not reflected in the test year of a future rate application.[4] The adjustment to the test year revenues that APS proposes is inappropriate precisely because it is an adjustment, rather than a decrease in revenues as a result of a DSM program actually resulting in lower revenues during the test year. RUCO has not changed its position in any way. It has consistently held that the Settlement Agreement prohibits the recognition of a net lost revenues adjustment.

In addition to the fact that the Settlement Agreement prohibits APS' net lost revenue adjustment, RUCO offered two other reasons the adjustment is inappropriate. First, the adjustment is based on APS' *estimates* of revenue decreases that have not yet been realized, and therefore it is not known and measurable. APS minimizes this point by claiming that its adjustment "merely" recognizes the impacts of DSM expenditures that occurred during the test year and in 2006.[5] However, while the amounts APS spent on DSM programs during the test year and in 2006 may be known, the revenue impacts of its DSM programs, most of which were not even implemented until after the test year, are

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[3] Decision No. 67744 at paragraph 46 to Settlement Agreement (excerpted as Exh. RUCO-5).
[4] *Id.*
[5] APS Brief at 68.

estimated. In fact, APS suggests that its DSM programs are in their initial stages, to the point that it would not even characterize them as "up and running."[6]

RUCO also objects to the net lost revenue adjustment because it results in a mismatch between the rate making elements used to set rates. It would result in recognition of revenue decreases beginning in 2006 and later, but not recognize revenue increases over the same period due to customer growth.

Staff's objections to APS' net lost revenues adjustment overlap with RUCO's in some respects, and are different in others. APS mistakenly claims that RUCO and Staff both argued that the adjustment would result in double compensation because APS is entitled to receive a performance incentive pursuant to the terms of the Settlement Agreement.[7] RUCO's objections to the DSM net lost revenue adjustment was based on the three points discussed above, not on any claim of double-recovery. RUCO has no objection to APS receiving the performance incentive under the terms of the Settlement Agreement. However, whether or not APS qualifies for the performance incentive, recognition of the net lost revenues adjustment is unjustified.

Pension Expense

APS proposes that the Commission increase rates by $44 million per year to "pre-fund" its pension. APS asserts that there is no reason to believe the

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6 APS Brief at 118.
7 APS Brief at 121.

under funding will be eliminated or reversed on its own.[8] But nearly one-third of APS' 2005 pension costs consisted of the "catch-up" amortization.[9] Further, APS admits that the under funding is mostly attributable to lower than normal interest rates used to discount the pension obligation to calculate the required pension plan contribution.[10] It is not difficult to envision that over time, interest rates would return to more normal levels, thereby reversing the under funding situation. Now, in an environment of repeated rate increases, is not the time for the Commission to accelerate the collection of pension expense for an under funding that is likely to correct itself over time without extraordinary Commission action.

APS also asserts that its accelerated pension recovery proposal will have a perpetual benefit because it will result in higher fund balances and will have a "levelizing impact on rates."[11] But increasing rates to an unnecessarily high level now, only to maintain them at that level later, is no benefit to customers.

PWEC & Sundance O&M Expense

APS characterizes RUCO's proposed adjustments for PWEC and Sundance Operations and Maintenance ("O&M") expense as being premised on lower operating levels of the plants.[12] Unfortunately, APS has oversimplified RUCO's position. RUCO's adjustment with respect to the PWEC units O&M expenses begins by correcting the actual expenses from which APS made further adjustments. APS began with the actual expenses for the calendar year

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[8] APS Brief at 60.
[9] Exh. S-34 at 82 (Dittmer direct).
[10] APS Brief at 60.
[11] APS Brief at 60, 61.
[12] APS Brief at 57 (Sundance) and at 56 (PWEC).

2004. RUCO corrected that to the test year, October 2004 through September 2005.[13] RUCO has not objected to the concept that generating unit O&M expenses be adjusted to account for projected levels of operation (which can differ from year to year based on maintenance schedules and other factors). The difference between RUCO and APS' positions is which projections to use. For the PWEC units, APS relied on projections made in 2005, of usage levels over the years 2006-2011. Pro forma adjustments for plant performance should be based on very specific known and measurable information; thus, more near-term generation forecasts are usually preferred. However, APS' most recent projections of the PWEC units' 2007 and 2008 generation levels differ significantly from their 2006 levels, and therefore the 2006 levels would not be representative of expected conditions.[14] RUCO therefore proposes that O&M expense be based on average projected performance over the years 2006-2008. RUCO's adjustment to Sundance O&M also is based on projected performance over the period 2006-2008, which is significantly lower than the performance level utilized by APS.[15]

In its testimony, APS responded that Staff's consultants' operation audit of generating units found the O&M patterns were consistent with system operational requirements.[16] RUCO's surrebuttal testimony replied that the Staff audit was of the historic O&M expenditures, and that it does not conflict with RUCO's

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[13] Exh. RUCO-29 at 4 (Schlissel direct).
[14] Exh. RUCO-29 at 7 (Schlissel direct).
[15] Exh. RUCO-30 at 9 (Schlissel direct).
[16] APS Brief at 56, 57.

adjustment to forecasts of future O&M expenses.[17] APS has not disputed that testimony. Additionally, Staff itself finds RUCO's adjustment consistent with Staff's audit conclusions. Staff's witness Dittmer proposed his own adjustment to APS' Sundance O&M projected expenses, and testified that his adjustment and RUCO's adjustment are not mutually exclusive.[18] Mr. Dittmer also concluded that RUCO's adjustment to the PWEC O&M is not unreasonable.[19] Clearly, Staff itself does not see its audit report on historical operation expenses as being inconsistent with its own, or RUCO's, adjustments to future period projected expenses. The Commission should not reject RUCO's adjustments to PWEC and Sundance O&M expenses based on the Staff operation audit conclusions.

Miscellaneous expense (lunches)

In its brief APS indicates that it is not aware of another instance when a party proposed disallowance of the cost of company-provided meals for employees. However, the fact that a party has not previously objected to an expense is no basis for concluding that the expense is appropriate. Further, APS has not established that other utilities have even sought recovery of such expenses.

Lobbying Expense

APS claims that prior Commission decisions have disallowed lobbying-related expenses, not because they are *per se* improper, but because the utility

[17] Exh. RUCO-31 at 1-2 (Schlissel surrebuttal).
[18] Exh. S-34 at 95 (Dittmer direct); Tr. At 4184-85 (Dittmer).
[19] Exh. S-37 at 50-51 (Dittmer surrebuttal) and Tr. At 4186 (Dittmer).

had not demonstrated that the lobbying activities produced benefits for customers.[20] APS further argues that it has provided evidence that its lobbying activities have provided benefits to customers, and thus those expenses should be recovered from customers. However, APS' evidence merely demonstrated that customers received benefit from certain lobbying efforts. APS did not claim that it had demonstrated that customers received benefit from all of the lobbying efforts for which APS is seeking recovery. Further, it is undeniable that shareholders also received benefit from APS' lobbying efforts, and thus they should pay a portion of the costs. RUCO's proposed adjustment is to disallow only a portion (approximately $785,000) of the lobbying costs sought by the Company.

Amortization Expense

APS' requested amortization expense was $10 million higher than its actual test year amortization expense. APS asserts that it calculated its amortization expense by multiplying the current authorized amortization rates by the individual asset costs and lives of amortizable assets.[21] However, APS has never provided the evidence necessary for RUCO to verify that APS performed the calculation that it claimed.[22] The Commission should not permit APS to recover a level of expenses merely because it claims the level is the correct one. APS is obligated by the Commission's rules to maintain the accounting records necessary to provide complete information about its operations, including its

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[20] APS Brief at 71.

[21] APS Brief at 66; Exh. APS-57 at 18-19 (Rockenberger rebuttal).

[22] Exh. RUCO-26 at 16 (Diaz Cortez surrebuttal).

expenses.[23] Further, once a party has challenged APS' requested expense level, APS has the burden to produce evidence that it is reasonable.[24] It has not done so in this instance.

Over the course of the test year, the balance of amortizable assets increased 5.5%, but APS is requesting a 35% increase in amortization expense above the test year expense level.[25] At the hearing, APS' witness suggested that the disparity between the change in asset balance and the change in amortization expense could be explained by a change in the distribution of assets at the various amortization rates.[26] However, APS has never demonstrated that it actually experienced such a change in make up of its amortizable assets.[27] APS cannot merely claim that its calculation is correct and decline to provide the evidence to support its claim when its result is counter-intuitive in the face of other data.

In the absence of the data to verify the accuracy of APS' requested amortization expense, RUCO has estimated an appropriate amortization expense. While RUCO's approach may be unusual, it was necessary due to the lack of substantiation for the Company's request. RUCO recognizes that the amortizable plant balances have increased by $29 million over the course of the test year, and estimates the appropriate adjustment to amortization expense by multiplying the plant increase by the composite amortization rate. RUCO's

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23 A.A.C. R14-2-212(G)(1).
24 Decision No. 68487 at 21.
25 Exh. RUCO-24 at 28 (Diaz Cortez direct); Tr. at 3424 (Diaz Cortez).
26 Tr. at 2606 (Rockenberger).
27 Tr. at 2607 (Rockenberger).

adjustment still permits a 12% increase in amortization expense,[28] which is more than generous considering that there was only a 5.5% increase in the plant balances.

Incentive Pay

APS provides two bonus compensation plans for employees—an incentive pay plan, and a stock bonus plan. RUCO has proposed a disallowance of 20% of the cost of the incentive plan, but has not opposed the stock bonus plan. Staff on the other hand has allowed the cash-based incentive plan, and disallowed the costs of the stock bonus plan. RUCO and Staff's proposed disallowances are similar in dollar amounts--$4.5 million and $4.8 million, respectively.[29] RUCO's disallowance is based on a policy recommendation that ratepayers should not be expected to shoulder the entire incentive program that allows APS employees to earn additional compensation, when APS customers have seen repeated increases in their electric rates over the past 24 months. RUCO has not suggested that the Commission adopt both its adjustment and Staff's. While the two adjustments may target different aspects of the Company's incentive compensation plans, RUCO believes adopting either one would be appropriate.

Property Tax Expense

RUCO has proposed an adjustment to the Company's property tax expense to recognize a decrease in the property tax rate that was adopted in

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28 Exh. RUCO-26 at 16 (Diaz Cortez surrebuttal).
29 See RUCO's Initial Closing Brief at 21 and Staff's Post-Hearing Brief at 31.

2006. The Company has responded that if the 2006 tax rate change is recognized, the Commission should also recognize a 2006 change in the assessed value to which the property tax rate is applied.[30] APS further claims that the matching principle requires that rate recovery match with actual expenses to be incurred when rates are in effect.[31]

APS' brief has mischaracterized the matching principle, which has led it to an improper conclusion regarding the necessary adjustment to property taxes. APS witness Froggatt correctly noted that the matching principle, which is a convention not only of regulatory rate making, but also of accounting principles in general, requires a proper matching of the accounting elements (revenues, expenses and rate base, for utility accounting) over the same period of time.[32] The matching principle is not about matching revenue levels with the level of expenses incurred in a post-test year period. If the matching principle were what APS' brief has claimed, the concept would have no application as a general accounting convention, because the pricing of goods and services generally is not based on accounting, but on market forces. In rate making, however, prices are set by the regulator based on costs, as demonstrated in the utility's accounting records. Thus, APS' brief's definition of the matching principle is completely at odds with the statement of its own Vice President and Controller Mr. Froggatt.

APS' suggestion to base property tax recovery on the 2007 assessed value improperly matches the various rate making elements. Even if the 2007

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[30] *See* APS Brief at 64.
[31] *See* APS Brief at 63.
[32] Tr. at 2318 (Froggatt).

assessed value is based on plant values as of December 31, 2005 as APS claims, that date is still beyond the end of the test year. Staff's witness agreed that the APS proposal to use the 2007 assessed value would create a mismatch.[33] Staff likewise agrees with RUCO's adjustment recognizing the decrease in the property tax rate.[34]

COST OF CAPITAL

Capital Structure

APS requests that its rates be set with a 54% common equity ratio. RUCO proposed a capital structure of 50% equity and 50% debt. APS argues that RUCO's proposed capital structure would undoubtedly reduce the Company's credit to non-investment grade.[35] However, APS overlooks the fact that its parent, Pinnacle West, which has higher operating risk than the Company, and thus would be expected to rely more heavily on equity, is capitalized with approximately 50% equity. APS also overlooks the fact that it maintained an investment grade bond rating before its recent capital structure shift, when it had approximately 45% common equity in its capital structure.[36] It is not appropriate for the Company, which has less risk than its unregulated parent, to have its rates determined with a capital structure that contains more common equity than that of its parent. Additional debt in a capital structure is appropriate for a company with less financial risk and thus less risk of default. The Commission

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33 Tr. at 4188-89 (Dittmer).
34 Staff Brief at 35.
35 APS Brief at 24.
36 Exh. RUCO-11 at 26.

should adopt RUCO's recommended capital structure of 50% equity and 50% debt.

APS further objects to RUCO's proposed "phantom" capital structure, claiming that it ignores APS' current reality.[37] However, it is not unusual for a utility regulator to base rates on a capital structure that contains less equity than the utility actually has, on the basis that the actual capital structure may be imprudent.[38] APS also objects to RUCO witness Stephen Hill's comparison of APS' 46% debt-54% equity capital structure to capital structures of other utilities, claiming that Mr. Hill included short-term debt and financial ratios of utilities with junk ratings in his comparison.[39] There are many reasons to consider short-term debt when determining an appropriate capital structure, including the facts that it is not possible to reliably claim that construction is funded only by short-term debt, that regulated firms consistently use short-term debt, that bond rating agencies include short-term debt when calculating debt-to-capital and interest coverage ratios, and that failure to consider lower-cost short-term debt would result in overstatement of overall cost of capital.[40] In addition, Mr. Hill relied on many barometers to reach his conclusion that his 50-50 capital structure was a more appropriate capital structure for setting rates than APS' actual capital structure.[41] Further, though Staff witness David Parcell did not propose an alternative capital structure, Staff agrees with Mr. Hill that APS' actual capital structure contains a higher equity ratio than that of electric utilities in both its

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37 APS Brief at 23.
38 David Parcell, The Cost of Capital—A Practitioner's Guide, 4-22, (1997)
39 APS Brief at 23.
40 Exh. RUCO-13 at 26-27 (Hill surrebuttal).
41 Tr. at 2125 (Hill).

general and specific proxy groups, and therefore APS's capital structure reflects a lower financial risk than that exhibited by the proxy groups.[42]

Return on Equity

For the most part, the Company maintains that only the cost of capital models that result in the highest returns should be relied on by the Commission in determining a fair rate of return on equity. While the Company claims to have considered the discounted cash flow ("DCF") model in its recommendation, in truth the Company, as even Staff concluded, " virtually ignored the results of the most commonly-used cost of capital methodology" – the DCF Model.[43] According to the Company, RUCO's application of the DCF model "... produces downwardly biased and even illogical results."[44] However, RUCO's 9.25% DCF recommendation closely approximates Dr. Avera's DCF recommendation of 9.0%.[45] The Company's criticism of RUCO's DCF results is curious given that RUCO's DCF results are even higher than the Company's.

The Company believes that RUCO's DCF results are illogical and downwardly biased because one could apply a different DCF analysis to RUCO's proxy group and achieve a much higher result.[46] The Company claims that applying the multi-stage DCF model to the reference group used by RUCO in its

[42] Staff Brief at 41.
[43] Exh. S-8 at 35 (Parcel direct), APS Brief at 20-21.
[44] APS Brief at 22.
[45] In its brief, APS refers to Dr. Avera's 9.0% DCF recommendation without any updates. APS Brief at 20.
[46] APS Brief at 22.

DCF analysis results in a 10.7% return on equity.[47] The Company's argument lacks merit.

The multi-stage growth formula suffers from two fundamental flaws, which is the reason why the standard DCF model or constant growth model is generally accepted in the industry as more reliable.[48] First, the multi-stage DCF makes more specific, detailed assumptions about the market than the constant growth DCF model, and it is therefore more likely to be inaccurate (i.e., with more detailed assumptions about specific events in the future, it is more likely to be wrong).[49] Second, it is often assumed that the final growth stage of the multi-stage DCF Model will equal Gross Domestic Product ("GDP") growth – the average growth rate of the entire economy.[50] In reality, that is not a reasonable assumption.[51] A comparison of GDP growth rates over the past 50 years shows that utilities grow at a rate about half the GDP.[52]

The Company analysis used to restate Dr. Hill's DCF analysis to arrive at a 10.7 return on equity suffers from the second flaw.[53] Substituting a growth rate equivalent to one-half of the projected GDP growth rate (which matches actual historical results) would produce an average multi-stage DCF result of 8.0%.[54] Therefore, if the Commission gave weight to the Company's consideration of a multi-stage DCF, the result would actually be an 8.0% return on equity, a full 125 basis points lower than RUCO's recommendation.

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47 *Id.*
48 Exh. RUCO-13 at 21 (Hill surrebuttal).
49 *Id.*
50 *Id.*
51 *Id.*
52 *Id.*
53 *Id.* at 22.
54 *Id.*

It is ironic that the Company would argue for the use of a multi-stage DCF analysis since the Company's 9.0 % DCF recommendation is based on a constant growth analysis.[55] In fact, Dr. Avera, the Company's witness, used the multi-stage formula in several cases several years ago but had not seen fit to rely on it in his Direct Testimony in this case.[56] The Company's logic regarding the multi-stage DCF and its overall return on equity recommendation should be rejected.

The Commission should reject the Company's recommended return on equity, because it focuses only on the highest results presented by its witness. RUCO's proposed return on equity is based on an analysis of several models, and should be adopted.

RATE DESIGN/RATE SPREAD

Several intervenors propose that rates be moved toward cost of service. However, all parties' witnesses on rate spread agreed that cost of service is not the sole factor to be considered in setting rates.[57] As discussed in RUCO's Initial Brief, rates were moved toward cost of service in APS' last rate case less than two years ago, and there have been numerous increases due to fuel costs since that time. Rate stability and continuity are necessary now more than ever.

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[55] *Id.* at 21.
[56] Exh. RUCO-13 at 21 (Hill surrebuttal).
[57] Tr. at 2911 (Rumolo); at 2979 (Baron); at 3029 (Higgins); at 3704 (Goins); at 3768 (Andreasen).

DEMAND SIDE MANAGEMENT

Interest on DSM adjustor

APS has apparently misunderstood the basis for RUCO's objection to APS' claim for interest on the demand side management ("DSM") adjustor. APS states that RUCO has claimed that APS should be precluded from recovering interest on the DSM mechanism because APS has failed to spend the full amount of DSM that was included in base rates.[58] However, RUCO's position is based on the lack of language in the Settlement Agreement providing for interest on the DSM adjustor balance. RUCO's reference to the fact that APS had not yet spent the $10 million included for DSM in base rates was merely to demonstrate the irony in the timing of APS' request. While customers received no interest during the period APS spent less than customers were paying for DSM programs, APS is now seeking interest as we enter the period in which APS is expected to be spending more than $10 million per year on DSM programs, and recoverying the incremental amount the following year through the adjustor mechanism. However, RUCO's primary concern is that it would be inconsistent with the terms of the Settlement Agreement for APS to recover interest on the DSM adjustor balance.

Post-2008 DSM obligation

APS objects to RUCO's proposal that the Company be required to spend at least $20 million per year on DSM programs beginning in 2008. APS claims that the $4 million increase RUCO proposes is unnecessary, and suggests that it

[58] APS Brief at 120.

is premature given that the existing DSM programs are new (and APS suggests it is overstating to say that they are "up and running"). Ironically, APS believes the programs are sufficiently "up and running" to request recovery of net revenues APS believes it will lose as a result of the programs' operation. APS cannot simultaneously claim that the programs are resulting in lost revenues and that the programs are not up and running.

POWER SUPPLY ADJUSTOR/BASE COST OF FUEL

Base cost of fuel

APS agrees that RUCO and the Company are "relatively close" in their proposals for the base cost of fuel.[59, 60] The primary difference between RUCO's and APS' positions is attributable to the use of 2006 (RUCO) and 2007 (APS) forecasts.[61] Staff likewise objects to APS' use of 2007 forecasts, which have not been subjected to the same level of scrutiny parties were able to apply to the 2006 forecasts APS relied on in its direct testimony.[62] Fuel forecasts are complex to perform and subject to both judgment and error.[63] APS' attempt to modify their request mid-case prevented parties from having sufficient time to review the 2007 forecasts in sufficient depth to rely on them as being accurate.

RUCO's proposed base cost of fuel and purchased power is 1.29 mils below APS' proposed level, and would result in approximately an additional

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[59] APS Brief at 34.

[60] As it did in it Initial Brief, RUCO will use the term "fuel" to refer both fuel and purchased power, unless otherwise stated.

[61] APS Brief at 33-34.

[62] Staff Brief at 7.

[63] *See also* Staff Brief at 7.

$38.7 million of additional carryover balance to be recovered in 2008.[64] APS claims that its proposal would result in a carryover balance of $58 million.[65] Thus, RUCO's proposed base cost of fuel would result in a carryover balance of approximately $97 million, still below the $110 million that would be recovered in 2008 through a 4 mil adjustor. RUCO's proposed base cost of fuel is reasonable and should be adopted.

<u>90/10 sharing mechanism</u>

Throughout the course of this proceeding, APS has advocated a PSA mechanism that retains the 90/10 sharing provision of the current PSA. In its Initial Brief, however, APS has changed course and suggests that the mechanism be eliminated, characterizing the mechanism as a "penalty provision." [66] Intervenor Arizona Utility Investors Association ("AUIA") likewise recommends that the 90/10 sharing mechanism be abandoned, claiming that because APS' growth is met by high-cost resources, fuel costs will increase even if fuel prices stabilize.[67] These parties overlook the purpose of the sharing mechanism. It is not to serve as a penalty, but to create an incentive that aligns APS' interests in acquiring fuel with the interests of customers who will ultimately be paying the costs of prudently acquired fuel through the PSA.

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[64] Based on APS' claim of 1 mil lower base cost of fuel results in $30 million increase in the deferral balance. *See* APS Brief at 34.
[65] APS Brief at 33.
[66] APS Brief at 35.
[67] AUIA Brief at 14.

To a large extent, Staff's fuel audit in this proceeding confirmed that APS has been prudently managing its fuel procurement.[68] However, Staff's conclusion is an indicator that the existing 90/10 sharing mechanism is serving its purpose. Eliminating the incentive would leave the Commission and APS' customers with no assurance that APS will continue to minimize overall fuel and purchased power costs. Further, APS had agreed to the 90/10 sharing mechanism in a time when growth was being served by higher fuel cost resources. The fact that total fuel costs are unlikely to decrease even if prices stabilize is nothing new, and is no reason to reject the mechanism now. The appropriate action to minimize the impact of this phenomenon on APS is to increase the base cost of fuel from its current level, which APS, Staff and RUCO have all recommended.

Finally, APS' recent problems with Palo Verde Nuclear Generating Station's performance may signal that the 90/10 sharing mechanism may not be enough of an incentive by itself to insure that APS operates its generation fleet in the most appropriate manner. Now is not the time to eliminate the 90/10 sharing mechanism, especially since no party has proposed any replacement incentive mechanism.

ENVIRONMENTAL IMPROVEMENT CHARGE

APS foresees investing a large amount of capital into environmental improvements of its plants, and uses that fact as the justification for seeking

[68] Even with the existing 90/10 sharing mechanism, Staff's audit found a number of areas where the Company could improve its fuel procurement practices. See APS Brief at 79-86.

special rate making treatment to recover its investments in environmental improvements. APS' proposal is for a form of an adjustor mechanism that it calls an environmental improvement charge ("EIC"). APS proposes that through the EIC, it be permitted to collect the costs it budgets each year for environmental improvements over the upcoming twelve months.

RUCO has no objection to APS investing in technologies that will result in generating facilities having less negative environmental impacts. However, investment to protect the environment, especially investment that is otherwise required by law, is no justification to discard the traditional rate making model that requires a rate case so that the Commission can examine all the moving parts of the rate making formula in determining rates. Environmental protection has always been a part of a utility's obligation, and the existing rate making model has proven adequate to fund the necessary investment. Single-issue rate making via an adjustor mechanism is not appropriate for recovery of such investments.

APS correctly notes that all adjustor mechanism are examples of single-issue rate making. However, only certain types of expenditures qualify for recovery through an adjustor mechanism—recovery of other expenses must comply with the Arizona Constitution's requirement that rates only be changed as part of a rate case finding a utility's fair value rate base.[69] The expenses for which an automatic adjustor are appropriate are expenses over which the utility has no control, and which constitute a significant portion of the utility's expenses

[69] *See Scates v. Ariz. Corporation Comm'n*, 118 Ariz. 531, 535, 578 P.2d 612, 616 (App. 1978).

such that even a small change in price will have a noticeable effect on its rate of return.[70] The Commission has also required that only expenses that are particularly volatile are recoverable through an adjustor mechanism.[71] APS' environmental compliance investments do not meet these criteria, and should not be recovered through an adjustor mechanism.

EXTRAORDINARY RATE MAKING METHODS

The extraordinary rate making methods that APS proposed in this proceeding were not part of the Company's initial request for rate relief, but only arose later in the proceeding. APS has only requested consideration of such devices to "bridge the gap" between the amount of its requested rate relief and an amount that the Commission might otherwise authorize based on adjustments proposed by Staff and intervenors.

APS concedes that the primary driver of its rate request is fuel costs, which make up 72% of its total requested increase.[72] While Staff and RUCO dispute the degree to which APS requires any additional rate relief above its fuel costs, APS, Staff and RUCO are all recommending PSAs that will substantially accelerate APS' fuel recovery.

APS suggests that the four extraordinary rate making devices it proposes be used to address any shortfall between rates that the Commission would otherwise authorize, and rates that APS claims are necessary to satisfy Wall

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70 Op. Att'y Gen. 71-15 at 2 (1975).
71 See Decision No. 68302 ("adjustment mechanisms should therefore be used only in extraordinary circumstances to mitigate the effect of uncontrollable price volatility or uncertainty in the marketplace."); Decision Nos. 68176, 66849.
72 APS Brief at 1.

Street's concerns. While the Commission should not set rates based on Wall Street's requirements in the first place, Wall Street's expectations are likely not as high as APS claims. Wall Street does not generally expect that regulators will grant the entirety of a utility's requested rate relief. Standard & Poor's recognized the Commission's January and May 2006 actions accelerating fuel cost recovery as generally constructive decisions,[73] but in neither instance did the Commission grant APS the full relief it was seeking. Likewise, in the equity report APS attached to its Initial Brief, Credit Suisse stated that it was "somewhat amazed [Great Plains Energy] got virtually all that it asked for."[74] There is ample evidence that it is unnecessary for the Commission to add on to what it otherwise finds to be fair rates in order to satisfy an alleged Wall Street expectation that APS would receive the full rate increase that it has requested.

APS claims that the decreasing return on equity it has experienced over the past five years is evidence that its requirement for large capital expenditures has negatively impacted its ability to earn its allowed return.[75] However, the Commission should not overlook the impact that under-recovery of fuel costs may have played in APS' results. Until the PSA was put in place less than two years ago, APS' rates had no mechanism for rates to track changes to fuel costs. And since the PSA has been in place, fuel cost volatility has exceeded the PSA's ability to automatically provide timely recovery without additional Commission action. Thus, during the last five years, when fuel prices have been particularly volatile and markedly increasing, one cannot attribute APS' failure to earn its

[73] Exh. APS-4 at 13-14 (Brandt direct).
[74] *See* APS Brief Exhibit 3.
[75] APS Brief at 30.

allowed returns exclusively to large capital expenditures to meet growth. Further, the additional flexibility in APS' proposed PSA (with which RUCO agrees) will allow the mechanism to more smoothly accommodate both changes to fuel prices and growth's impact on the amount of fuel APS requires.

CONCLUSION

Over the last two years, the Commission has repeatedly acted to increase APS' rate recovery, particularly through the adoption of the PSA mechanism and the two subsequent actions to allow additional recovery above that normally permitted by that mechanism. The Commission has also permitted APS to acquire and rate base (albeit at a discount) the generation assets formerly owned by its unregulated affiliate, to the benefit of both APS and customers who will continue to have access to those resources. Any suggestion that the Commission has overlooked APS' opportunity to recover adequate rates is misguided. The Commission should continue to balance APS and customers' interests using its traditional rate making methods that have served the public well.